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DOES GEORGIA NEED A UNITARY TAX?

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Executive Summary

State corporate income taxes imposed on multi-state corporations can be based on unitary reporting (also referred to as combined reporting) or on separate entity reporting. Unitary reporting, employed in sixteen states, requires a corporation to combine for tax purposes the net income of all related companies. The unitary entity then apportions its profits to the state using the state's apportionment formula. Georgia, in contrast, permits separate entity accounting. This allows each separate company of a parent corporation to report its own income and apportion it to Georgia based on the Georgia apportionment formula. This report discusses the advantages and disadvantages of these two approaches to corporate income taxation.

One of the principal concerns with the separate entity accounting is that, multi-state firms can use separate accounting to legally reduce taxes payable to a state like Georgia. These legal avoidance schemes involve the use of so-called Delaware holding companies or other nexus defeating strategies. For example, a Georgia company can set up a company in Delaware and transfer all of its intellectual property to that new company. The new company can then charge the Georgia company for the use of its trade and service marks, patents, and trade secrets. This reduces taxes payable to Georgia since these payments are legitimate business expenses. (Since Delaware does not tax income generated from intangibles, the firm pays no taxes in Delaware and thus reduces its total state corporate taxes. An alternative scheme is for the company to restructure itself to put a portion of its assets in its entities located in states with no income taxes (or in states with lower taxes). This also may reduce the apportioned income to Georgia, leaving the state with lower tax receipts. A unitary tax would eliminate the value of these avoidance activities.

Unitary taxation has some appeal because it appears simple, equitable, and it may increase corporate tax receipts. Unitary taxation is simple in the sense that once a unitary business is defined, then the determination of the corporate income tax is simple. In addition, the state does not have to determine whether a transaction between two related entities was an arm's length transaction or one done for the purposes of tax avoidance. Unitary taxation is fair because similar companies are

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treated in a similar manner. Sophisticated tax planning will not benefit taxpayers, so those that have the resources to avoid taxes do not obtain a competitive advantage over other taxpayers. Finally, unitary taxation has the ability to increase the corporate income tax base and, thus, increase tax receipts.

However, there are some concerns regarding the use of unitary taxation. First, the tax is not as simple as one might think. Determining what a unitary business actually consists of is not obvious and experts may differ in the application of the tests for a unitary business. California has a well-established unitary tax. However, even if a state adopted California's administrative rules and court interpretations as the basis for the tax law, there will still be fact-sensitive cases that may lead to a divergence of opinion between what would be decided in California and in the adopting state. This could arise from the interaction of the facts, the state law, and the state Constitution.

The unitary tax also appears to raise state income tax receipts when state income is increasing. However, it appears to also be more sensitive to decreases in state income. Thus, during those times when the state is likely to need corporate income tax revenues, the state will not be able to rely on them to the same extent that a separate accounting state would be able to rely on the corporate income tax revenue.

Finally, the unitary tax has a bad reputation throughout the United States, due primarily to the unitary tax policy used at one time by California. California adopted what is called worldwide unitary taxation. Under this option, the income of all related entities, including those located outside of the U.S. were combined for California corporate income tax purposes. Foreign companies objected to the imposition of the tax and threatened to remove investment from states with worldwide unitary tax policies. While California altered its approach to limit the effect of the unitary tax to those entities with nexus in the United States, the appearance of unfair application of the tax still exists. There is evidence of a strong bias against the tax by business and this bias may be enough to divert future investment away from states with unitary taxes. Thus, in the very long run, it may be that future income tax receipts are reduced. Adopting the unitary tax may also be

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inimical to the business environment of the state and be inconstant with the general state approach to promote economic development.

There are a number of options available to Georgia regarding the corporate income tax. One option is to scrap the tax. This would not be a large revenue loss since it only brings in approximately four percent of state tax revenues. If the corporate income tax was repealed, then Georgia would be the only state in the Southeast without a corporate income tax. This may make Georgia more appealing to all business investment and not just those able to take advantage of the various economic development credits built into the current law.

If Georgia decides that it must have a corporate income tax, there are a number of alternatives in addition to the unitary tax for addressing the tax avoidance issue. One option is to disallow the use of intellectual property holding companies. These holding companies allow Georgia taxpayers to legally avoid the payment of taxes. Repeal of this ability to legally avoid taxes will put Georgia in line with a number of states, including some of Georgia's close neighbors.

If horizontal equity is a strong rationale for altering the corporate income tax, then a second option, switching to a value added tax (VAT), may be a preferred approach. There would not be incentives for overreaching by the tax authorities that might occur in a unitary tax, nor is there any incentive to invest in tax avoidance schemes. Further, even with a low tax rate, a VAT is likely to generate greater and more stable tax revenues than the current corporate income tax.

Finally, if Georgia decides to adopt a unitary tax there are two main options, a worldwide formula or a water's edge formula. Every state with a worldwide approach has either repealed the unitary tax or allowed the taxpayer to choose the approach it desires. As the worldwide approach is such a negative for potential international investors, this approach is not practical. A water's edge approach is favored by the states employing the unitary tax. However, no state in the Southeast uses any type of unitary tax. The use of such a tax may put Georgia at a competitive disadvantage for future investment within the state.

I. Introduction

Georgia, like most states and the federal government, experienced a secular decline in corporate tax receipts over the last two decades.¹ The problem of reduced tax receipts is particularly noticeable at a time when other tax receipts are also declining as a result of the recent economic downturn. A number of methods are available to increase the revenue performance of the corporate income tax. Among these are eliminating economic development credits, taxing so-called pass through entities such as sub chapter S corporations, imposing a value added tax, increasing the tax rate, or increasing the tax base. This report focuses on a particular proposal that effectively increases the corporate income tax base: the unitary (or combined income) tax approach for the assessment of corporate income taxes. In essence the unitary tax allows for the mandatory combination (for tax accounting purposes) of related companies operating inside and outside the state.²

For many companies, especially those with operations outside the state, the imposition of a unitary tax could increase the underlying tax base. The imposition of the unitary tax may increase a state's short-run corporate tax revenues, but because of structural reasons and economic incentives, the imposition of the tax could have a long run negative impact on corporate tax revenues and potentially on the perceived business climate and potential economic development within the state.

¹ See e.g. Wallace (2000), Jenny (2002), and Grace (2002).

² A previous FRC report (Grace 2002) provides an overview of Georgia's corporate income tax.

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Georgia allows corporate entities to submit separate income tax returns based on each individual corporate entity's income within a related group.³ Traditionally, the law and many states' tax policies treat each corporation as a separate legal entity. This so-called "separate accounting" is permitted specifically in Georgia.⁴

In contrast to separate accounting is the combined reporting (or unitary reporting) requirements like those of California.⁵ California requires firms with a unitary business to combine income and expenses from the "unitary" business.⁶ This combined net income is then apportioned by the use of California's apportionment rule and the tax rate is then applied to the combined net income to determine the tax liability.

Currently, some 16 states employ some version of the unitary approach.⁷ There are three main versions of the unitary tax: worldwide combination, water's edge combination, and 80/20 combination. Worldwide combination refers to the approach California took prior to 1988.⁸ This approach required any corporation

³ It is important to distinguish between the filing of "combined income reports" and the filing of "consolidated returns". These two terms are at times used interchangeably, but they are quite different. The objective of combined income reporting is not to tax the income of the affiliated group as a whole or file a consolidated return. Rather, the objective is to determine the portion of the income from the unitary business attributable to the companies with nexus, i.e. operating, in the state. The combined income report is an informational return rather than a tax return. Each corporation in a combined report with nexus in the state still has to file its own corporate tax return. By contrast, in a consolidated return the total net income of the corporations in the group is filed in a single return and a single tax is paid (even though each of the corporations is jointly and severally liable for payment). In the case of consolidated returns, net income is not limited to that related to a specific unitary business. Of course, when the consolidated business operates in more than one state, apportionment will be necessary in the consolidated return. See Rules of Department Of Revenue, Income Tax Division, Chapter 560-7-3 Substantive Regulations, <http://www2.state.ga.us/departments/dor/inctax/newregs/reg-consolidated-ret.pdf>.

⁴ See, O.C.G.A. § 48-7-30 - §48-7-31 (2002).

⁵ California Code § 25110 - § 25111 (2002).

⁶ Determining the parameters of a unitary business is difficult. The Multistate Tax Commission recently held hearings on this very issue. This is discussed further below.

⁷ According to the Multistate Corporate Tax Guide (2002) these states are Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, North Dakota, Nebraska, New Hampshire, Oregon, and Utah. Montana did not respond to the Tax Guide's survey. However, from examining its corporate income tax law, it appears to allow a water's edge election for multinationals. Thus, Montana is also classified as a unitary tax state.

⁸ See e.g. California Code 25111(d) (2002). California employed a worldwide unitary approach prior to tax year 1988. Due to pressure by various foreign governments and international businesses, California adopted the water's edge approach.

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doing business in California to combine with worldwide related businesses. A number of multinational corporations such as Barclay's Bank, Container Corporation, Colgate and Sony believed the tax to be unconstitutional as it attempted to tax value supposedly created outside the state. However, as will be discussed below the Supreme Court upheld the constitutionality of the tax.

A second method for assessing the unitary tax is the water's edge approach. This is the method California currently employs.⁹ This would require combination of any related businesses doing business within the United States. Thus, if Sony Corp had subsidiary operation in California, the combination required would only include those other Sony owned corporations with U.S. operations. Thus, European or Asian operations of Sony (with no U.S. nexus) would not be included in the unitary tax combination.

A third approach is also used by some states such as Illinois which requires an unitary tax return. If, however, 80 percent or more of property and employment comes from outside the United States, that business need not be combined for unitary tax purposes. This so-called 80/20 rule limits further the application of forced combination to those companies with more than a minimal presence in the United States.

Unitary taxation solves some specific problems for the state. Most importantly, it can reduce the ability of companies to avoid the state's corporate income tax through tax planning. For example, suppose there is a Georgia company called AutoLease Inc. Suppose further, AutoLease actually owns two types of property in Georgia. It has tangible assets in the form of cars and it has intangible intellectual property in the form of copyrights, trademarks, and trade secrets for the business. To minimize AutoLease's tax liability, AutoLease Inc. can form a holding company in Delaware and transfer its intellectual property to the Delaware holding company. Further, the Delaware holding company would bill AutoLease a license fee for the use of the intellectual property in Georgia. This fee is a deductible expense

⁹ In fact, California technically still has the worldwide unitary tax, but it will allow companies to elect to be taxed based on the water's edge approach. See the California Water's Edge manual (2003) at http://www.ftb.ca.gov/manuals/audit/water/_toc/WEMFront.html.

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and thus reduces AutoLease's tax liability in Georgia.¹⁰ Further, since Delaware does not tax corporate profits for the intellectual property holding companies, AutoLease experiences a net gain in after tax income. Georgia suffers a net reduction in tax receipts.¹¹

Table 1 shows a stylized example where AutoLease's stylized tax return is examined before and after adoption of a Delaware holding company (DHC) arrangement. In this stylized case AutoLease pays \$6 of corporate income tax to Georgia prior to the use of the DHC arrangement. After the DHC is formed, AutoLease pays tax of \$1. What is particularly interesting is that the lease fee for the intellectual property can be variable, thus a DHC could charge its leasees their entire state corporate profits as the fee. Thus, Georgia could conceivably lose 100 percent of its corporate income tax revenue from AutoLease. A unitary tax would require the combination of the DHC and AutoLease Inc. for Georgia tax purposes. Thus, Georgia would be able to recover the tax receipts lost by the use of the DHC.

¹⁰ Georgia faced the scenario described in the AutoLease example in *Aaron Rents Inc. v. Marcus E. Collins, Sr.*, No D-96025 (Fulton County Superior Court, June 27, 1994). *Cert den.* Georgia Supreme Court (August 24, 1994). Other states have also faced this problem some have sided with the taxpayer (Missouri) *Acme Royalty Co. v. Director of Revenue and Gore Enterprise Holdings v. Director of Revenue* (Mo. S. Ct. Nos. SC84225 and SC84226, November 26, 2002)), but many sided with the state (Maryland), *Syl, Inc. v. Comptroller*, No. C-96-0154-01, Md. Tax Ct., 1999 Md. Tax LEXIS 3 (Apr. 26, 1999) overturned in *Comptroller v. SYL Inc. & Comptroller v. Crown Cork and Seal Company* (Md. Ct. App. June 9, 2003), (South Carolina) *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 *cert den.* 510 U.S. 992 (1993), Massachusetts, *(Syms Corp. v. Commissioner of Revenue*, Mass. Appellate Tax Board, Nos. F215484 and F228324 (Sept. 14, 2000) and New Mexico, *In the Matter of Kmart Properties, Inc.*, NM Rul. No. 00-04 (Jan. 31, 2000) and (New York) *In the Matter of the Petition of the Sherwin-Williams Co.*, NYS Tax Appeals Tribunal, DTA No. 816712 (June 5, 2003).

¹¹ Simpson (2002) reports that state tax "experts" believe that the Delaware Holding Company is costing the states billions in lost revenue. The Multistate Tax Commission issued a report in 2003 suggesting the state corporate income tax losses for 2001 ranged between \$8.32 billion and \$12.38 billion. See, MTC (2003a).

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TABLE 1. EFFECT OF DELAWARE HOLDING COMPANY ON AUTOLEASE INC.'S TAX PAYABLE TO GEORGIA

AutoLease Inc.

Panel A. Simplified Tax Form for Tax Year 2003		
1	Revenues on Leases	\$1,000
2	Tax Deductions (Labor and other Business Expenses)	\$ 900
3	Taxable Income (Line 1 - Line 2)	\$ 100
4	Tax Due to Georgia (Line 3*6%)	\$ 6
Panel B. Simplified Tax for Tax Year 2003 (with License Fee Paid to Delaware Holding Co)		
1	Revenues on Leases	\$1,000
2	Tax Deductions (Labor, License Fee and other Business Expenses)	\$ 990
3	Taxable Income (Line 1 - Line 2)	\$ 10
4	Tax Due to Georgia (Line 3*6%)	\$ 0.60

This report examines the use of the Unitary Tax in Georgia. The next section provides a legal background to the use of the tax. Section III addresses the pros and cons of imposing the tax in Georgia. Section IV examines how some of the policy options available to Georgia. Finally, Section V contains a summary and conclusions regarding the use of the unitary tax in Georgia.

II. Legal Background on the Unitary Tax

A. History of Unitary Tax Litigation

Three important parts of the U.S. Constitution affect the state's ability to tax. The state can not unduly burden interstate or foreign commerce (commerce clause), the state can not tax without a proper connection between the taxpayer and the state (due process clause), and the state can not discriminate in an irrational manner between like taxpayers (equal protection clause). If we look at each constraint, we can see the constitutional concerns brought about by the unitary tax.

In *Complete Auto Transit v. Brady*¹² the U.S. Supreme Court developed a four part test to determine if a state tax would be permissible under the Constitution. Under the Court's test, a tax is permissible if (1) it is applied to an activity with a substantial nexus to the state; (2) it is fairly apportioned; (3) it does not discriminate against interstate commerce; and (4) it is fairly related to the services provided by the state.¹³

The tests announced in *Complete Auto Transit* are essentially fairness tests where each test focuses on a different dimension of state tax policy. If there is a substantial nexus between the taxing state and the taxpayer, for example, then it is proper under the due process clause of the Constitution to tax the taxpayer. Thus, there must be minimum contacts between the state and the taxpayer such as ownership of property within the state, employing workers, or some other way of establishing a presence in the state. A state fails the due process requirement if it attempts to tax a corporation on "value earned outside its borders."¹⁴ Taxpayers in unitary states complain that the unitary combination effectively taxes out-of-state income.

Next, proper apportionment is also a requirement for fairness and is meant to make sure that the state does not overreach and claim nexus for economic activity outside the taxing authority of the state and place a burden on interstate commerce.

¹² 430 U.S. 274 (1977).

¹³ *Id.* at 430 U.S. at 279, (1977).

¹⁴ *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980).

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Taxpayers in unitary tax states have asserted that the apportionment may cause what amounts to double taxation. The Supreme Court has essentially put the burden of proof on the taxpayer to show this to be the case.¹⁵

Further, a state tax must also satisfy the equal protection clause. This test requires that a state have a rational basis for taxing a company in a particular manner. This is a relatively easy test to pass as the Supreme Court has generally declined to uphold only those taxes that discriminate against out-of-state companies at the expense of in-state companies.¹⁶

The final test is likely to be the most subjective as it requires the tax to be in line with the benefits provided by the state. No unitary state taxpayer has asserted this as a critique of the unitary tax. However, if we look at all state tax policies, we see that there is a large variance in policy and presumably all states are nominally within the constitutional guidelines.

The *Complete Auto Transit* case described the boundary of all interstate taxation, but the Supreme Court acted further in a number of cases to provide some guidance as to what constitutes a unitary entity. McIntyre *et al.* (2001) summarize the various determinants as

- A unity of use and management;¹⁷
- A concrete relationship between the out-of-state and in-state activities that is established by the existence of a unitary business;¹⁸
- Functional integration, centralization of management, and economies of scale;¹⁹
- Substantial and mutual interdependence;²⁰
- Some sharing and exchange of value beyond the mere flow of funds from a passive investment.²¹

¹⁵ See e.g. *Barclay's Bank PLC v. California Franchise Tax Board*, 512 U.S. 298 at 317. (1994).

¹⁶ *Metropolitan Life Insurance Company v. Ward*, 470 U.S. 869 (1985) (The Court struck down Alabama tax that discriminated against out-of-state insurers because state could not justify a rational basis for differential treatment under the equal protection clause.)

¹⁷ *Butler Bros. v. McCollgan*, 315 U.S. 501, 508, 62 S. Ct. 701, 704 (1942).

¹⁸ *Container Corp. v. California Franchise Tax Board* 463 U.S. __ at 166.

¹⁹ *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, at 438 (1980).

²⁰ *F.W. Woolworth Co. v. Taxation and Revenue Dept. of New Mexico*, 458 U.S. 354 at 371 (1982).

²¹ *Container*, 463 U.S. at 166. See McIntyre et al (2001) pp. 718-719 and cases cited therein. These are also discussed further below in Section II.B.

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These characteristics need to be present for a state to properly combine entities and tax them as a unitary business. A state's unitary tax *could* be constitutionally suspect if it overreached in terms of requiring companies to combine companies the state could not otherwise tax. In *Container Corporation v. California Franchise Tax Board*,²² for example, the State of California applied its unitary tax. Container Corporation was a Delaware corporation with operations in a number of states, including California, and other countries. Container Corporation asserted that California did not have the right to force a combination to tax the company's worldwide income. The Court held that the combination of Container Corporation's worldwide business was permissible especially since California employed the standard equally weighted three-factor apportionment formula to allocate profits to the state. The use of this apportionment formula is, essentially, enough to bring the unitary tax within the Constitutional requirements. The three factor formula permits the state to tax in proportion to the economic activity within the state relative to the rest of the world.

California was sued again, on almost the same facts, by Barclay's Bank.²³ The only real difference between *Barclay's Bank* and *Container Corp.* is the fact that Barclays is an alien corporation. The Supreme Court was not sympathetic to Barclay's argument. It upheld California's right to tax on a unitary bases in conjunction with a fair apportionment methodology. What is interesting is that California's worldwide approach to combination attracted a great deal of negative attention, especially from the federal government and foreign governments.²⁴ This pressure forced California to change its practice of taxing worldwide income to one

²² 463 U.S. 159 (1983).

²³ *Barclays Bank PLC v. California Franchise Tax Board* 512 US 298 (1994).

²⁴ Both the United Kingdom and Japan were particularly interested in reducing the effect of the worldwide combination. After *Container Corp.* the British Parliament passed a law authorizing the United Kingdom Treasury to deny advance corporation tax credits on dividends paid by U.K. subsidiaries to multinational corporations having significant activity in states such as California employing the worldwide unitary method. See generally Fiamma (1985) and Perris (1985). For a more thorough treatment of the history of California's law see, Coffill (1983). The U.S. Department of the Treasury also was interested in the California's tax policy because of pressure from other countries. See e.g., U.S. Department of the Treasury, Worldwide Unitary Taxation Working Group (1989).

where combinations would only be required for operations within the United States. This “Water’s Edge” approach limits combinations of U.S. and alien corporations to those operations with nexus to the United States.

B. Standards for Unitary Taxation

The general framework for when a firm needs to be combined with other firms to report on a unitary basis is not necessarily simple. The Multistate Tax Commission (MTC 2003b) has proposed guidelines for determining the existence of a unitary business²⁵ which it defines as:

... a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly owned or controlled group of business entities that are significantly interdependent, integrated, and interrelated through their activities so as to provide a synergy or exchange of value to the separate parts.²⁶

This broad definition of a unitary business will allow a state to assert nexus over a company and its related companies to combine income to be taxed on an apportioned basis. Further, a single entity may have more than one unitary business. This can occur if more than one business operates different trades or services. For example, an auto manufacturer might have a manufacturing subsidiary and a credit subsidiary. This company may have two unitary businesses within the state: one relating to manufacturing and the other related to auto loans.

More specifically, the MTC’s proposed rule would recognize a unitary business by the so-called “flow of value” approach described by the Supreme Court in *Mobil Oil Corp. v. Vermont*.²⁷ In this case the Supreme Court held a unitary business could be found if there was a functional integration, centralization of management, and economies of scale. Under the proposed MTC rule, these three

²⁵ Hereinafter referred to as MTC Rule.

²⁶ MTC, Rule § I(A).

²⁷ 445 U.S. 425 (1980). Mobil Oil Corporation, domiciled in New York, was contesting the application of Vermont’s corporate income tax which taxed foreign source dividends earned outside the United States.

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factors would provide evidence of integration or interdependence sufficient for the activities to be combined for tax purposes.²⁸

Under the proposed rule functional integration refers to “transfers between, or pooling among business activities”²⁹ significantly affecting the operation of the business.³⁰ Functional integration might be evidenced by, among other things, sharing of technical information, sharing of intellectual property, use of a common distribution or procurement systems, use of a common marketing scheme, as well as use of a common company financing system.³¹

A second fact to be examined is the presence of a centralized management structure. This can be determined by examining how the senior management exerts control over decisions, subsidiaries, or other corporate entities. Evidence of a common management structure can be inferred when “common officers participate in decisions relating to the business operations of the different segments.”³²

Finally, economies of scale are the value a firm receives from operating at an increased scale of operation. An example of the type of evidence needed to show the existence of economies of scale would be the presence of common procurement systems, accounting, payroll, and pension systems, or legal departments.

The proposed rule provides guidance on when an inference of a unitary business can be made. First, is the “same type of business test.” If the company is in the same line of business as a potential combined entity, then it is in the same line of business. While this sounds tautological, it appears to be difficult to apply. The example given in the proposed rule is the multistate grocery chain. This combination seems obvious. However, what about a financial service company that sells commercial banking services in one state and mortgage loans in another. Again, we

²⁸MTC Rule, § II(A).

²⁹MTC Rule, § II(B)1.

³⁰Note that these and the other factors that determine whether a company should be combined for tax purposes are factual questions normally determined by a jury in Georgia.

³¹MTC Rule § II(B)1(a)–(f).

³²MTC Rule § II(B)2(a). Note that this finding of fact ignores the separateness of the corporate form that in all areas of corporate organization is sacrosanct.

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are forcing fact finders to decide questions that do not really have an underlying logical basis for uniformly determining an outcome.

The second test is whether the business activities are steps in a vertical process. The example provided in the proposed rule is that of a natural resource extraction company that explores, mines, processes, and markets natural resources. This can be a unitary activity even though there is little link between the exploration function and the marketing function.³³

A third test is whether there is strong centralized management in the unitary organization. The rule contemplates the scenario where there may be separate business entities like those found in a conglomerate that would not be unitary but for the fact that there is a strong central manager. The presence of the central manager coupled with centralized departments (purchasing, financing, legal, research) provides evidence of a unitary business.³⁴

There are constraints written into the rules, however. For example, separate corporations can be combined for the purpose of a unitary tax only if they are members of a “commonly controlled group.”³⁵ The commonly controlled group is defined through common ownership. This general requirement is evidenced by one business entity owning 50 percent or more of another. The rule is more detailed but the idea is to limit a combined return to those commonly controlled companies.

These rules are provided as an indicator of how a state would combine corporations for unitary tax purposes. While the rules may be relatively simple in theory, their application is more complex generating differences of opinion between taxpayers and tax departments. In fact, as can be seen by the proposed rule, the determination of whether the business activities are a unitary business is fact intensive.

Even if most of the law regarding the unitary tax is well developed, as the MTC hearing officer reports, there is still a complaint that the proposed rule does not

³³ MTC Rule, § III(B).

³⁴ MTC Rule, § III(C).

³⁵ MTC Rule, § IV.

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provide a bright line for determining a proper unitary entity.³⁶ This problem may cause substantial uncertainty regarding a corporation's tax liability. This is one potential problem with the law that is discussed in the next section which describes some of the pros and cons of employing the unitary tax.

³⁶ *Multistate Tax Commission, Hearing Officer's Report Recommendation Concerning the Proposed Revision of the MTC's Allocation and Apportionment Regulation IV.1(b) Setting Forth Principles for Determining the Existence of a Unitary Business* (September 10, 2003) at <http://www.mtc.gov/UNIFORM/HearingOfficerReportUnitaryBusiness091003.pdf>.

III. Pros and Cons of Unitary Taxes

A. Pros

McIntyre, Mines, and Pump (2001) suggest three main benefits of combined reporting: (1) better measurement of in-state income; (2) protection against tax-minimization strategies; and (3) simplification. The first argument is essentially an equity argument. The second argument also relates to equity in the sense that companies would not be able to use holding company arrangements and/or separate accounting for out-of-state companies to obtain a tax advantage over a company that for whatever reason can not legally avoid taxes. The third rationale, simplification, is a laudable goal, but it is debatable as litigation and uncertainty will develop under a new tax scheme.³⁷ There is also a fourth goal of increasing state corporate income tax revenues or, at least reducing the rate of revenue decline.³⁸

Better Measurement of In-State Income. By employing a combined reporting scheme it will be possible to determine a more equitable tax base reflecting the economic activity occurring within the state. This rationale favoring the unitary tax is essentially based upon horizontal equity. Corporations can tax plan to avoid the incidence of the corporate income tax by setting up a Delaware Holding Company (DHC) and transfer profits to the DHC to avoid the corporate tax.³⁹ While all companies can conceivably do this, those that do not will end up bearing the burden of the corporate tax. This will put further stress on corporate tax revenues in the sense that the incentives to legally avoid the tax become greater.

This can be seen by the following example. Suppose two competing firms exist in Georgia. One sets up a DHC and reduces its effective tax rate to zero. This

³⁷ The authors argue that if a state mimics the California unitary tax law then the state will be able to take advantage of all of the litigation experience the California law has generated --thus saving costs. However, this may not as easy to do in practice as it seems as these cases are extremely fact sensitive. Litigation and uncertainty will still be present even if a state were to copy California's law due to the interaction between the legal environment, the state constitution, and the unique set of facts that these cases seem to continually generate.

³⁸ Grace (2002), among others, describes the state corporate income tax as a leaky tax. Tax revenues have diminished over time in many states due to decreases in the corporate tax rate, increases in economic development credits, and increases in the income tax planning and the use of holding companies to shelter income.

³⁹ Another name for these corporations is an intellectual property holding company.

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firm now has a competitive advantage over its rival as it could price lower. Alternatively, if it does not reduce prices it can provide its owners with an increased dividend which avoids the state corporate income tax. This advantage will force competitors to seek tax avoidance strategies in order to stay competitive, thus reducing overall corporate tax revenues.

Protection Against Tax Minimization Strategies. A second tax avoidance strategy that is allowed under separate accounting, but would be reduced under combined income reporting, would be “nexus defeating strategies.” For example, a multistate company could conceivably put some of its assets in different, but related corporations. As long as the new corporations do not have nexus within the state, they are not liable for income taxes in the state. Companies can do this by setting up corporations in states with no corporate income tax or by setting them up in states with relatively low tax rates.⁴⁰

A related problem is that one need not use a DHC or nexus avoiding strategies as methods of tax avoidance. One can also use pass-through accounting organizational structure to avoid the corporate income tax. Companies can organize themselves as limited liability corporations (or elect sub chapter S status). In doing so, corporate profits are distributed to the shareholders of the corporation without a corporate income tax being placed on the net income generated by the corporate activity.

Corporations that can elect to organize themselves as limited liability companies in Georgia to take advantage of the tax pass-through provisions are those who can elect to be treated as a pass-through entity. Further, larger companies can use the DHC route to legally avoid paying the corporate income tax in Georgia. It is important to note that the burden of the corporate tax likely falls on the owners of corporations that can not avoid the tax through a DHC or altering the structural form of the corporation to a pass-through entity. In effect these are likely to be Georgia C

⁴⁰ When companies do this they essentially create corporate income that may be taxed nowhere. Some states believe this to be inequitable and require that the companies “throwback” this income to the state where it can be taxed. Georgia does not require throwback of income earned in those states that have no corporate income tax.

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companies with no income earned outside the state and without any real intellectual property assets. This group is likely to be relatively small.⁴¹

Simplification. McIntyre, Mines, and Pump (2001) suggest that using the combined report is simpler than using separate accounting. Separate accounting, if done properly, requires that inter-corporation transfers be done using an “arm’s length” transfer price.⁴² That is, transfers between companies should reflect market values rather than a valuation derived by a tax avoidance benefit. Because the arm’s length prices are difficult to determine, it is easier to combine the entities into a unitary taxpayer. The state would no longer have to look at individual transactions to make sure they are valued appropriately.

Increased Revenues or Revenue Stability. One benefit of a unitary tax is that tax revenue losses due to avoidance mechanisms like those employed by firms with Delaware holding companies could be reduced. Thus, unitary tax states should have a higher growth rate of real corporate income taxes. Further, the net amount of state corporate income taxes collected should be greater in states with unitary taxes, all other things held constant. Table 2 shows that the ratio of corporate income tax receipts to state domestic product is greater in the unitary states than in the separate accounting states. This suggests that on the surface unitary states appear to have higher tax collections relative to gross state product. We also see the growth rate in state income (measured as the real state domestic product) for unitary states is slightly greater than the growth rate of state income for separate accounting states. We also see that the real growth rate in tax collections for unitary states is, on average, greater than for separate accounting states. Finally, the states are of different size in terms of average gross state product. Unitary states, on average, are smaller in

⁴¹ See, *IRS Statistics of Income*, SOI Bulletin, Historical Table, (Spring 2003) data calculated from information provided in *Selected Returns and Forms Filed or To be Filed by Type During Specified Calendar Years 1975-2003* (July 2003) for information about the growth in pass through entities. In 1975 Sub chapter s corporations accounted for 17.2 percent of corporate tax filings. In 2003 it is forecasted to be 57.28 percent. Similarly, pass through entities (partnerships and sub chapter S corporations) were approximately 50 percent of corporate returns in 1975, but the percentage is forecasted to be almost 70 percent in 2003.

⁴² This is the method the federal government uses for taxing corporations, see IRC § 482.

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TABLE 2. SUMMARY STATISTICS FOR STATES WITH CORPORATE INCOME TAXES, 1990-2001

<i>Panel A. Separate Accounting States</i>					
Variable	Obs	Mean	Std.	Min.	Max
Ratio of Corporate Income Tax Receipts to State GSP	372	0.0036	0.0015	0.0013	0.0095
Real Growth Rate in State Income	372	0.0211	0.0250	-0.0765	0.0975
Real Growth Rate in State Income Tax Collections	372	0.0008	0.1727	-0.6432	1.1020
Real State Product (\$000,000)	372	104,923	87479	8642	466679
<i>Panel B. Unitary States</i>					
Variable	Obs	Mean	Std.	Min.	Max
Ratio of Corporate Income Tax Receipts to State GSP	180	0.0043	0.0036	0.0013	0.0379
Real Growth Rate in State Income	180	0.0251	0.0335	-0.1470	0.0985
Real Growth Rate in State Income Tax Collections	180	0.0291	0.3507	-0.8032	3.2340
Real State Product (\$000,000)	180	78,033	156774	8542	772372

economic product than separate accounting states. While California is a unitary state and has a large economy, it dwarfs the other unitary states in terms of output.

B. Cons

The potential problems with the use of a unitary tax in Georgia are mostly practical. First, as long as each state has the power to determine how to tax corporations, there is an incentive to use state tax policy as an economic development tool. Thus, as long as Delaware or Nevada obtains some benefit from allowing the formation of holding companies, there will be an incentive to do so. Further, as long as corporations have an option to how they organize themselves for tax purposes, they will do so to maximize their profits.

Given that the Congress has not preempted any of the states' authority to impose (or not impose) state corporate income taxes, there will always be ways for companies legally to avoid paying taxes by using DHCs or other nexus reducing strategies. If, however, Georgia were to adopt a unitary tax policy then two things may occur. First, some companies may choose not to locate in Georgia and others may choose to restructure themselves to avoid creating nexus or any type of unitary business. The latter may be difficult, but the incentives would exist to attempt to do so.

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Income Sensitivity Differences. One of the problems with the unitary tax is the fact that the corporate tax revenues may become more sensitive to changes in the state's income. Table 2 shows that the standard deviation is greater for growth in income and tax receipts for unitary states than it is for separate accounting states. This suggests some differences in the sensitivity between income and tax receipts. I estimated a simple regression between the log of real corporate income taxes and real state product for the period 1990-2001 for each state with a corporate income tax.⁴³ Table 3 shows the average elasticity between tax receipts and state income for the unitary tax states and the separate reporting states. A tax with an elasticity estimate greater than one would be more sensitive to changes in income and a tax elasticity less than one implies that tax revenues are less sensitive to changes in state income.

Table 3 shows that the elasticity between corporate tax receipts and real domestic product is about three times higher in unitary states than in separate accounting states. This means that if the state's real income increases by 10 percent, the real corporate tax receipts increases by (approximately) 15 percent in unitary states, but it increases by only (approximately) 5 percent for separate accounting states.

TABLE 3. ELASTICITY BETWEEN CORPORATE TAX RECEIPTS AND STATE GROSS DOMESTIC PRODUCT FOR YEARS 1990-2000 FOR UNITARY AND NON-UNITARY STATES

	Unitary State	Separate Accounting State
Mean State Elasticity between Corporate Tax Receipts and State Domestic Product	1.458	0.525
Number of States	16	31

Note: means are different assuming unequal variances at the $\alpha = 0.05$ level of significance.

⁴³ There are two major caveats to be made with this analysis. First, is that most states have reduced their tax rates or their tax bases over the period of the 1990s. The state tax base has generally been eroded by economic development credits. I did not control for changes in the tax base. Second, I chose a recent 11 year period because I wanted to make sure that I did not contaminate the data with a potential secular shift in the economy between the 1980s and the 1990s.

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Another way to see how the unitary tax performs is to look at the percentage change in real state tax revenues on a year-to-year basis. By looking at increases from year to year (good years) versus decreases from year to year (bad years) we can see the effect of a unitary tax in good years versus bad years. Table 4 shows that during bad years both unitary and separate accounting states have negative percentage changes in real tax receipts, but that the unitary tax states have statistically larger negative changes than the separate accounting states. During good years, the unitary states have higher percentage increases than the separate accounting states although the statistical difference is only significant at the 0.10 level. Table 4 suggests that the effects of the unitary tax may be asymmetrical on the average state's corporate income tax receipts: in good years the receipt growth is better than in separate accounting states and in bad years the receipt growth is worse than separate accounting states.

TABLE 4. COMPARISON OF GROWTH RATES IN GOOD AND BAD YEARS FOR UNITARY AND SEPARATE ACCOUNTING STATES

	<i>Presence of Unitary Tax</i>		Statistical Difference
	No	Yes	
<i>Change in Tax Revenues</i>			
Negative Change in Tax from Previous Year	-0.1405	-0.1956	***
Positive Change in Tax from Previous Year	0.1069	0.1720	*
Statistical Difference	***	***	

*** Statistical difference assuming unequal variances at $\alpha = 0.001$ level.

* Statistical difference assuming unequal variances at $\alpha = 0.10$ level.

In addition to more volatile income tax receipts the unitary tax may cause firms to avoid investing within a state. A recent analysis of the unitary tax suggests firms may rationally react to the imposition of a unitary tax. Using a simulation model, Williams, Swenson, and Lease (2001) show that for a model firm, a change to a unitary tax will cause a firm to reallocate property, salaries, and sales towards a non-unitary tax state. This is consistent with supposition.

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Dynamic Concerns. While one might expect firms to reallocate resources from one state to another due to a significant change in tax policy, it may take a number of years to determine the effect this may have on state tax revenues. The tax base might increase at first, in the short-run, due to the imposition of a unitary tax. However, one cost resulting from the imposition of the unitary tax that is hard to gauge is the possibility of future declines in the growth rate of the Georgia economy. Thus, while the income elasticity of the unitary tax may be positive, it does not account for the loss of future growth opportunities. The presence of the unitary tax may be important for location decisions for firms deciding to come to Georgia and a firm with a choice may be more likely to choose a non-unitary state over a unitary state for a new investment, all other things held equal.⁴⁴ This is an efficient decision if the firm cares about minimizing its tax burden and is consistent with the simulation model presented by Williams *et al.* (2001).

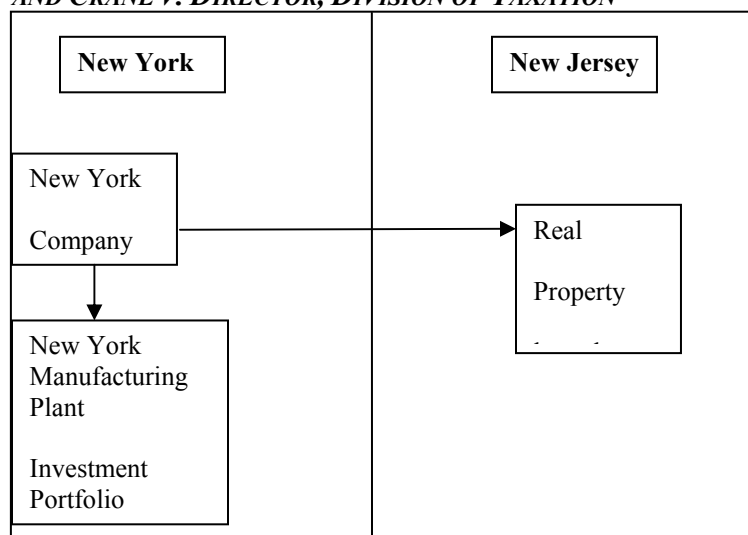
Administration of the Tax Law or “What is a Unitary Business?” Another problem with the unitary tax is the administration of the law. Each state could conceivably have a different definition of a set of business activities that would be called a unitary business as long as it followed the basic U.S. Constitutional guidelines described above. To provide some insight into the complications arising from determining whether a set of activities were unitary we can look to cases to see how the law is being interpreted.⁴⁵

⁴⁴ The former Georgia Revenue Administrator, Mr. Jerry Jackson, was relating a story at the Southeastern Association of Tax Administrators in Savannah in July of 2003. He stated that he would receive calls from consultants hired to find a new site for a plant and they would ask about whether Georgia had a unitary tax. Mr. Jackson said that he felt that the consultant did not even know what it was, but that it was at the top of the list of questions about taxes.

⁴⁵ While the examples shown here come from New Jersey, it is important to note the New Jersey is not a considered a unitary state. New Jersey still has a unitary issue but it comes from a different perspective. New Jersey requires the apportionment of all company income to New Jersey. An important distinction to make is the difference between allocable and apportionable income. Essentially apportionable income can be thought of as income from the sale of goods and services produced by the firm while allocated income is earned in a passive way. New Jersey attempted to tax all income from domestic and non-domestic companies, but the Supreme Court held that the state violates due process if the state attempts to tax beyond the boundaries of a unitary business. A state must properly define a unitary business prior to apportioning income to the state. See e.g. *Allied Signal v. Director Division of Taxation*, 504 U.S. 768 (1992).

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FIGURE 1. THE ORGANIZATIONAL STRUCTURE IN *SILENT HOIST AND CRANE V. DIRECTOR, DIVISION OF TAXATION*



In *Silent Hoist and Crane*⁴⁶, a New York company had manufacturing facilities and an investment portfolio in New York (see Figure 1). The company had no office, employees, agents, or investments in New Jersey, but it did have some sales in New Jersey. The New Jersey Division of Taxation asserted that Silent Hoist should have filed a unitary tax return. At trial the New Jersey Tax Court found for Silent Hoist on a basis that New Jersey did not really have nexus with the investment portfolio. The Appellate Division of the Tax Court agreed, but it was the New Jersey Supreme Court that found that Silent Hoist was a unitary business for New Jersey tax purposes.

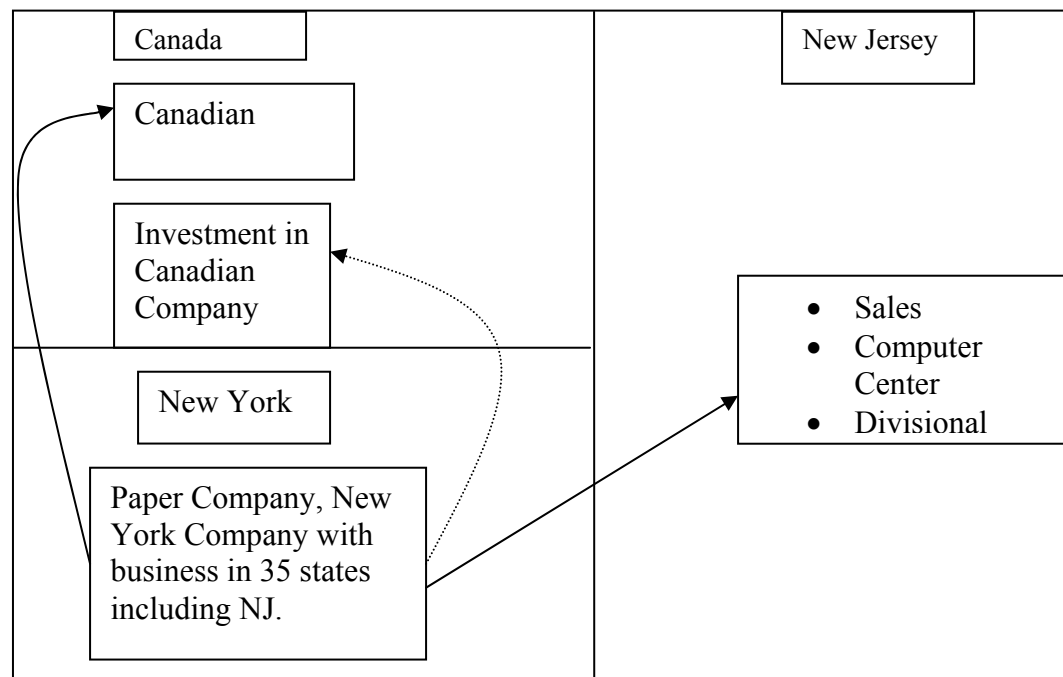
The New Jersey Supreme Court focused on the central management, finding a unitary business existed. Again, this is a fact sensitive determination and it is important to note that two tax courts, presumably experts in New Jersey tax law, came to a different conclusion than the New Jersey Supreme Court.

Figure 2 shows a second case. In this situation International Paper disagreed with a combination that would allow taxation by New Jersey of a capital gain

⁴⁶ 5 N.J. Tax 242 (NJ Tax Court, 1983). *aff'd*, 6 N.J. Tax 348 (N.J. App. Div., 1984), *rev'd* 100 N.J. 1, 494 A.2d 775 (1985) *cert. den.* 474 U.S. 995 (1985). See also Metzger (1997) for more details of the case.

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FIGURE 2. *INTERNATIONAL PAPER COMPANY V. DIRECTOR OF TAXATION*



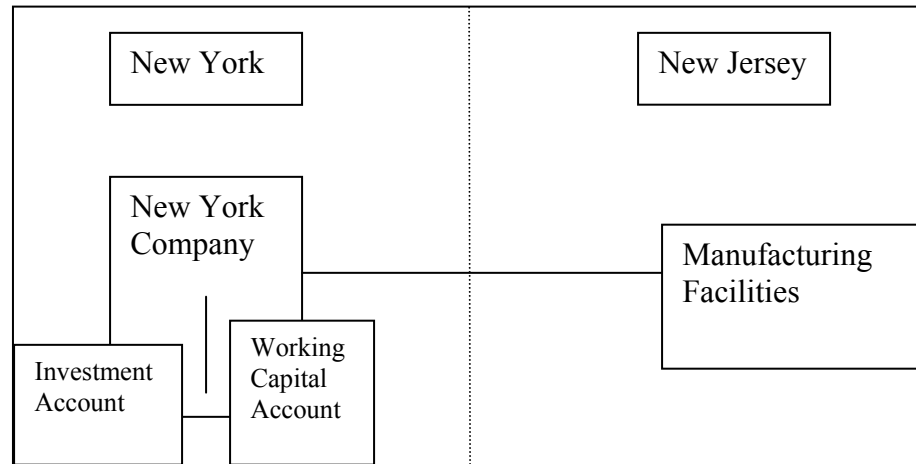
resulting from the sale of a subsidiary in Canada as well as the sale of some stock of a company that International Paper did not control, but had some 14 percent of the equity securities. The New Jersey Supreme Court held that the subsidiary was properly part of the unitary corporation due to the common control element as International Paper actually had an active, continuous, and substantial involvement with the subsidiary. However, for the investment in the Canadian Company that amounted to approximately 14 percent of the ownership, there was no substantial involvement and therefore this capital gain was not taxable in New Jersey.⁴⁷

A third case involves a New York Company with New Jersey manufacturing facilities (see Figure 3). The New York Company had two investment funds, one a general investment fund and the other a working capital fund. The investment fund held investments in other companies' securities, commercial paper, U.S. Treasury Bills, and certificates of deposit. The working capital fund was the financing arm of the company. At issue were the capital gains and dividends from the various

⁴⁷ See e.g. Metzger (1997) and 11 N.J. Tax 147 (N.J. Tax Ct. 1990), *aff'd*, 12 N.J. Tax 253 (App. Div. 1991), *cert. denied*, 127 N.J. 549, 606 A.2d 363 (1991).

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FIGURE 3. *AMERICAN HOME PRODUCTS V. DIRECTOR, DIVISION OF TAXATION*

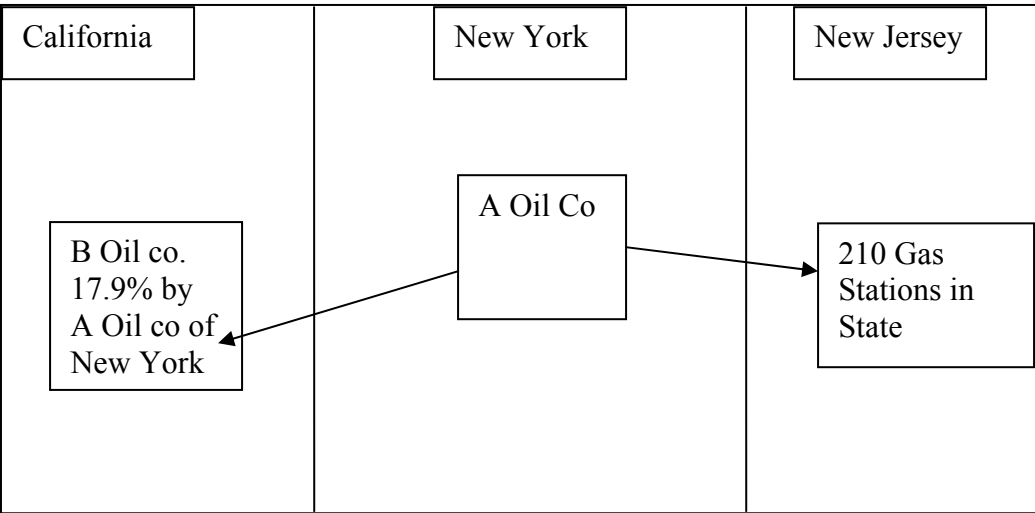


investments. The New Jersey tax administrator claimed that investments were not discreet business activities since the investment funds were commingled with the working capital funds. However, the New Jersey Tax Court held that these were in fact separate activities, but that the assets devoted to the working capital account were part of the unitary business.

A fourth case involves a Mobil Oil Company, a New York company with 210 gas stations in New Jersey.⁴⁸ Mobil sold a California subsidiary and realized a capital gain (see Figure 4). New Jersey wanted to tax that capital gain as income earned as part of a unitary business. Mobil argued that its investment was a passive investment and that it was not part of the unitary business. New Jersey's tax administrators disagreed because the subsidiary was in the same business as the oil company and the oil fields owned by the subsidiary were adjacent to those owned by the putative parent company. Further, Mobil managed its investment by attending the board meetings of the subsidiary. Finally, the tax administrators felt this was a different case than the *International Paper* case discussed above since the subsidiary and the parent are in the same business. In this case the New Jersey Tax Court found this to

⁴⁸ *Mobil Oil Corporation v. Director, Division of Taxation*, 11 N.J. Tax 334 (N.J. Tax Ct. 1990) *aff'd* 12 N.J. Tax 111 (App. Div. 1992).

FIGURE 4. *MOBILE OIL CORPORATION V. DIRECTOR, DIVISION OF TAXATION*



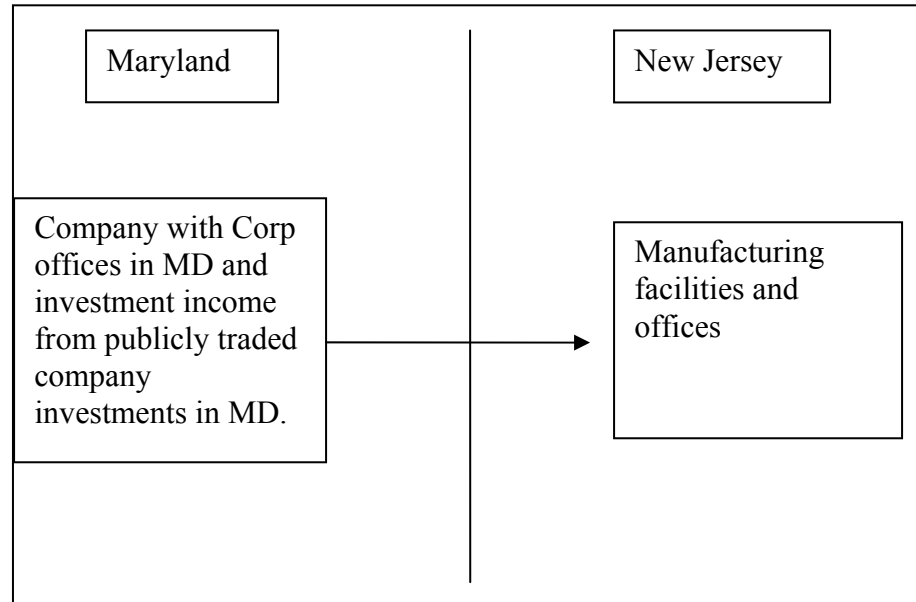
be a non-unitary business because the amount invested in the subsidiary was sufficiently small.

The last case discussed here is shown in Figure 5.⁴⁹ This case involved a Maryland company with corporate offices in Maryland, but it also had offices and manufacturing and distribution centers in New Jersey. The company had four businesses: (1) oil and gas exploration and production; (2) industrial and consumer manufacturing; (3) commercial real estate; and (4) marine transportation. It also held stock in publicly traded corporations which were commingled with all corporate funds. The tax administrator concluded the business was unitary and included the dividend income from the publicly traded companies as part of the business’s total income. For the tax years in question the amount of income generated by the investments ranged between 39.5 percent and 52.7 percent and contributed between 68.4 percent to 85.9 percent of the firm’s net worth. The tax court upheld the tax administrator’s determination.

⁴⁹ No. 07-14-0302-87CB, slip op. (Tax Ct. September 5, 1991) cited by Metzger (2003) fn 50.

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FIGURE 5. *AMERICAN TRADING AND PRODUCTION CORPORATION V. DIRECTOR, DIVISION OF TAXATION*



Because of cases like the ones described here, Colorado has attempted to make a bright-line test for determining whether an entity should be combined for tax purposes. Colorado's approach has a number of parts. First, a determination is made of whether there is common ownership. This is defined to be fifty percent or more ownership of one company by another. Second, if this ownership threshold test is met then a company is a unitary company with the affiliate if three or more of the following are present:

- Inter-company sales constitute fifty percent or more of the gross operating receipts of the affiliates;
- Five or more business services are provided to the affiliate (such as legal, R&D, accounting, marketing, etc.);
- Twenty percent or more of the long term debt of the affiliates are guaranteed or owned by other affiliates;
- One affiliate employs the intellectual property of another affiliate;
- Fifty percent or more of the officers and directors of one affiliate are corporate officers of the other affiliate;
- Twenty-five percent or more of the highest ranking officers of one affiliate are officers and directors of the other affiliate.⁵⁰

⁵⁰ See e.g. CRS § 39-22-303(11) (2003).

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Colorado's approach makes the determination of some aspect of a unitary business more clear. However, for cases like those described above, the Colorado approach does not add much value and litigation will still be required to determine tax liability.

IV. Policy Options

There are a number of options that Georgia could consider in addition to the adoption of a unitary tax.⁵¹ The options depend upon Georgia's goals. If, for example, Georgia would like to attract development to the state, then Georgia could repeal the corporate income tax. Repealing the corporate income tax would have reduced the state's tax overall tax revenues by approximately 4.3 percent, based on FY2002 revenues. Georgia would join Texas, Nevada, Washington, and South Dakota and Wyoming as states with no corporate income tax.

If Georgia desires to raise additional revenue from the corporation tax, then a unitary approach might be one of the options. As mentioned previously, there are essentially three flavors of mandatory unitary taxation: the worldwide unitary combination, the water's edge combination, and the 80/20 rule. There is also a fourth option and that is for states to force (or to permit taxpayers to elect) combination if it reflects more accurately the profits of the corporation. The use of the first three options of having the unitary combination as the default method of taxation will likely change Georgia's business climate. Using the fourth type of combination may yield some revenue, but there will be a number of contested returns as well as the potential for litigation on a variety of fact patterns.

What is interesting to note is that none of Georgia's neighbor states have the unitary tax in any form (see Figure 6). Florida enacted a worldwide unitary tax for a brief time in the 1983. It was revised and was repealed after only 1 year. While Florida enacted the law to address significant revenue shortfalls in the state, it was under immediate pressure to repeal the statute.⁵²

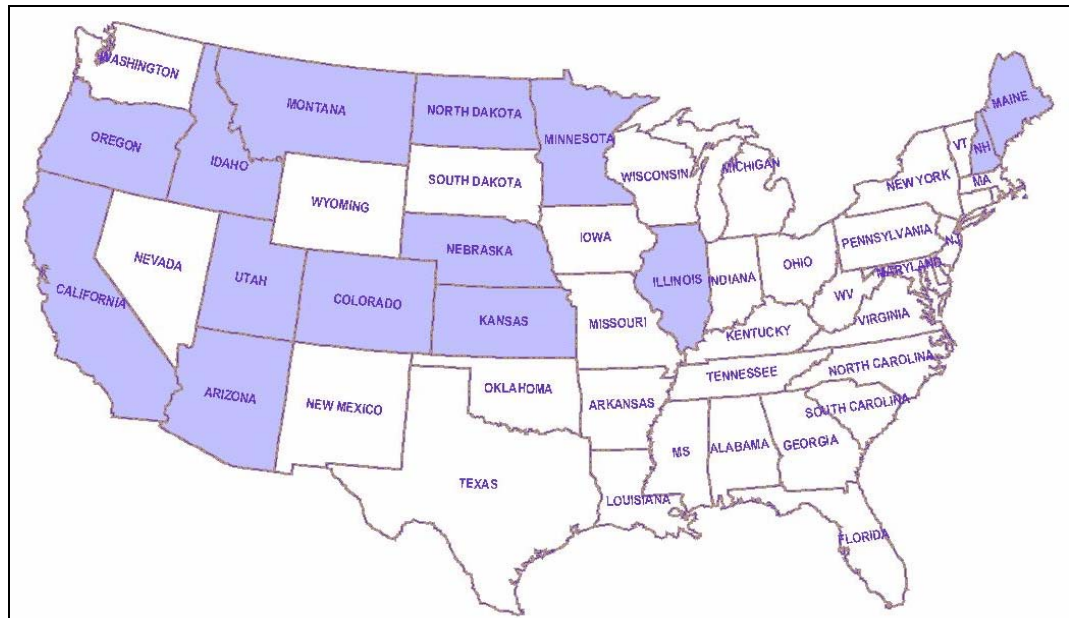
An alternative to the unitary tax exists if the goal is to raise additional revenues from the corporate tax base. This would be to remove the economic development credits currently permitted under Georgia law. These credits cost in

⁵¹ See also Grace (1998) and (2002) for a more complete discussion of these and other options regarding the Georgia Corporate Income Tax.

⁵² Fla. Stat. section 220.135, as amended by Laws of 1983, ch. 83-349; Fla. Laws of 1984, ch. 84-549.

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FIGURE 6. GEOGRAPHIC DISTRIBUTION OF STATES WITH UNITARY TAX POLICIES.



terms of lost revenue. However, by eliminating the credits Georgia would change its business climate to some degree.

Further, Georgia currently allows the pass through of profits earned by sub chapter S corporations and limited liability corporations. These revenues escape the corporate income tax in most states and are only taxed once rather than two times under the current interaction between the corporate income tax and the personal income tax. Many states tax pass-through entities at the state level.⁵³ These so called entity level taxes are generally at a lower rate than the general income tax.

If the holding company issue is the main issue, then Georgia could adopt legislation that prohibits firms from deducting licensing fees paid to related entities. A number of states currently do this to avoid the problem of the DHC.⁵⁴ Georgia

⁵³ See e.g. Multistate Corporate Tax Guide's section concerning the treatment of S corps in Multistate Corporate Tax Guide (2002).

⁵⁴ See e.g. Ohio Rev. Code Ann. §5733.052 (West Supp 2001). Iowa Code Ann § 422.61 (West 1998); Conn. Gen. Stat. Ann. § 12-218c (West 2000). Also Maryland, in 2003, considered a bill that would do this (HB753), but the governor vetoed it on May 21, 2003 http://mlis.state.md.us/2003rs/veto_letters/hb0753.htm. Pennsylvania's Governor proposed this same type of bill in May 2003.

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would have to amend its corporate income tax statutes in order to do this as the Georgia Supreme Court declined to prohibit the use of a Delaware holding company arrangement in the *Aaron Rents* case. However, more states are finding that their tax law prohibits this type of arrangement or they have specifically amended their statutes to prohibit this type of arrangement.

If Georgia were to legislatively repeal the tax deductibility of payments to related parties, then it would not necessarily put itself in a competitive disadvantage. Two states this summer rejected judicially the avoidance of state corporate tax income through the use of holding companies (Massachusetts and New York). This may be evidence of a future trend as lower courts in both states held for the taxpayer. Further, Florida rejected use of the intellectual property holding companies through a revenue rule (which is likely to be challenged).⁵⁵

Potentially, Georgia could spend resources on dealing with the transfer pricing issue. While undoubtedly expensive, it also may generate additional revenues. Under Georgia's current law the Department of Revenue has the authority to use "any other method to effect an equitable allocation or apportionment of the taxpayer's income."⁵⁶ The taxpayer could be required to provide the rational for the value of the transfer. This could reduce the incentives for companies to employ DHC as a method of tax avoidance if the Department of Revenue would spend resources on the policing of the transfers.⁵⁷

If fairness is an important issue in the sense that similar entities should be paying similar amounts of tax, Georgia could adopt a value added tax. The VAT is a tax applied to all commercial activities within the state involving the production and distribution of goods or the provision of services. At one level it appears to be a sales

http://216.239.51.104/search?q=cache:6TvwYy9RTUJ:www.philachamber.com/currentissues_st ate.asp+anti+%22delaware+holding+company%22+law&hl=en&ie=UTF-8

⁵⁵Florida Regulation, Rule 12C-1.011(p)(1) provides that a company has nexus for corporate income if it sells or licenses the use of intangible property to a business entity located in Florida. See also Comeau *et. al* (2001).

⁵⁶ See e.g. O.C.G. A. § 48-7-31 (d)(2)(D)(E)(iv).

⁵⁷ Arguably the Department of Revenue attempted to do this in the *Aaron Rents* case. Thus, it may take more than mere assertiveness on the part of the DOR to reduce the use of DHCs in Georgia. New Statutory authority may be required.

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tax, that is, it appears as a tax on a transaction. However, what makes it theoretically different is that it is actually a tax on the value-added in the production and distribution of goods or services.

The major benefits of the VAT are increased revenues, increased savings formation, and increased investment. For example, if a VAT were in place, it could conceivably cover the production of both goods and services. While Georgia taxes corporate income for goods and service providers, the sales and use tax generally does not cover the sales of services. Thus, broadening the tax by using a VAT base beyond the sale of goods could conceivably bring in significant revenue to the state. Of course the value added tax rate can be set to simply generate the same revenue as currently produced by the corporate income tax.

The use of a VAT in Georgia would likely be part of a significant tax reform as its imposition could likely affect the sales and use tax. Unlike New Hampshire, which just introduced a VAT, Georgia has significant revenue from the sale and use tax, as well as a corporate income tax. Thus, the revenue required from the VAT as a replacement for these taxes would be significant. However, Georgia could employ the VAT as a new complementary tax rather than a replacement of the corporate income and sales and use tax. In this case, the benefits to Georgia might be akin to the imposition of an alternative minimum tax. The VAT may be able to reduce the erosion of the corporate income tax, especially if it was applied to all business irrespective of corporate form.

V. Summary and Conclusions

The unitary approach to state corporate income taxation is employed in sixteen states. The unitary tax contrasts to the practice in Georgia as it requires combination of similar related entities into a combined taxpayer for income tax purposes. The net income of the combined taxpayer would then be subject to taxation in Georgia based on the state's apportionment formula. The unitary tax has some appeal because it appears simple, equitable, and it may increase corporate tax receipts. The unitary tax is simple in the sense that once a unitary business is defined, then the determination of the corporate income tax is simple. The state also does not have to determine whether a transaction between two related entities was an arm's length transaction or one done for the purposes of tax avoidance. The unitary tax is fair because similar companies are treated in a similar manner. Sophisticated tax planning will not benefit taxpayers, so those that have the resources to avoid taxes do not obtain a competitive advantage over other taxpayers. Finally, the unitary tax has the ability to increase the corporate income tax base and, thus, increase tax receipts.

However, there are some concerns regarding the use of the unitary tax. The tax is not as simple as one would think. Determining what a unitary business actually consists of is not obvious. Experts may differ in the application of the tests for a unitary business. Even if a state adopted California's legislation, administrative rules, and court interpretations as the basis for its tax law, there will still be fact sensitive cases that may lead to a divergence of opinion between California and the adopting state. This could arise from the interaction of the facts, the state law, and the state Constitution.

The unitary tax also appears to raise state income tax receipts when state income is increasing. However, it appears also to be more sensitive to decreases in state income. Thus, during those times when the state is likely to need corporate income tax revenues, the state will not be able to rely on them to the same extent that a separate accounting state would be able to rely on the tax revenues.

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Finally, the unitary tax has a bad reputation throughout the United States. This is due primarily to the unitary tax policy adopted by California which taxed the income of worldwide business of a unitary enterprise. Foreign companies objected to the imposition of the tax and threatened to remove investment from states with unitary tax policies. While California altered its approach to limit the effect of the unitary tax to those entities with nexus to the United States, the appearance of unfair application of the tax exists. There is evidence of a strong bias against unitary taxation by business and this bias may be enough to divert future investment away from states with unitary taxes. Thus, in the very long run, it may be that future income tax receipts are reduced. Adopting the unitary tax may also be inimical to the state's business environment and would be inconstant with the state's general approach to promote economic development.

There are a number of options available to Georgia regarding the corporate income tax. These include scrapping the tax since it only brings in approximately four percent of state tax revenues. If the tax was repealed, then Georgia would be the only state in the Southeast without a corporate income tax. This may make Georgia more appealing to all business investment and not just those able to take advantage of the various economic development credits built into the current law.

If Georgia decides that it must have a corporate income tax, there are a number of alternatives to the unitary tax that would potentially increase tax revenue. One, would be to disallow the use of intellectual property holding companies. These holding companies allow Georgia taxpayers to legally avoid the payment of taxes. Repeal of this loophole will put Georgia in line with a number of states, including some of Georgia's close neighbors.

If horizontal equity is a strong rationale for altering the corporate income tax, then a value added tax (VAT) may be a preferred approach. There would not be incentives for overreaching by the tax authorities that might occur in a unitary tax, nor is there any incentive to invest in tax avoidance schemes merely to avoid taxes. Further, a VAT could generate significant tax revenue at low tax rates, unlike the current corporate income tax.

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Finally, if Georgia decides to adopt a unitary tax, there are two main options. Georgia could use a worldwide apportionment formula or a water's edge formula. Every state with a worldwide approach had either repealed the unitary tax or allowed the taxpayer to choose the approach it desires. As the worldwide approach is such a negative for potential international investors, it is not practical. A water's edge approach is favored by the states employing the unitary tax and the use of the 80/20 limitation makes a strong statement about the limits to which the state will go to define a unitary business. However, no state in the Southeast uses any type of unitary tax. The use of such a tax may put Georgia at a competitive disadvantage for future investment within the state.

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Martin F. Grace is currently the Associate Director and Research Associate at the Center for Risk Management and Insurance Research Georgia State University. He is also an Associate in the Andrew Young School of Policy Studies, Fiscal Policy Center. Dr. Grace's research has been published in various journals in economics and insurance concerning the economics and public policy aspects of regulation and taxation. In particular, Dr. Grace has undertaken studies of the efficiency of insurance firms, insurance taxation, corporate taxation, optimal regulation of insurance in a federal system, and solvency regulation. Dr. Grace is a former President of The Risk Theory Society and he is a current associate editor of the *Journal of Risk and Insurance*. Dr. Grace earned both a Ph.D. in economics and a J.D. from the University of Florida in 1987.

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